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COMMENTS ON THE U.S. BALANCE-OF-PAYMENTS SITUATION

Address by George H. Chittenden
Vice President, Morgan Guaranty Trust Company of New York
At the September 1963 Meeting of the Cincinnati Council on World Affairs
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This subject of mine today, despite its intricacies and even despite its importance, is really a dandy in its own special way. Its most delightful characteristic is that no one really knows the whole subject, very few have rational or even credible views or opinions on it, and the whole picture has a habit of changing radically every time you pick up the daily newspaper. Implicit in this situation is the license for freedom of speech for people like me -- even in a city where I am a stranger and even in this company, which includes your Chairman Mr. William A. Mitchell. I used to work for and with Mr. Mitchell -- WAM, as he was irreverently referred to by the student body in J. P. Morgan & Co. It wasn't that Mr. Mitchell and his partners weren't interested in the theories and suggestions of the younger set -- they rather encouraged us in our efforts to overcome our collegiate naiveté -- but that we soon learned we'd better have our facts incontrovertibly in order, our arithmetic double-checked by the comptroller's department, and our presentation streamlined and precise. Otherwise, somehow or other, we soon gained the impression that we were wasting their time, and our own. So as you can see I am rather pleased to have a subject which so few, perhaps not even WAM, are really competent to handle with complete authority and with complete knowledge of all the mathematics concerned.

On the mathematical side, one might think that the statistics prepared by the unusually able and dedicated men in the Department of Commerce would be the definitive measure of our international viability. And they are in fact a unique and magnificent tribute to the skills, often derided and too seldom

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praised, of the professional statistician. But they lack, by their very nature, artistry. They are black and white, or black and red if you will. They lack shading, values. There is not the trace of the artist's brush, no bright splashes of color in the foreground, no grays and off-greens in the background. They have no personality, no qualitative feeling.

I don't quarrel with this, of course. Statistics have got to be assembled cold-bloodedly. If they weren't we'd be in a chaotic fix, as we tried to figure out what had happened from one period to another. But I do caution against a literal reading of statistics. In this subtle, complicated world of credit evaluations, and exotically-motivated, profit-conscious, even socially-conscious capital movements, the user of statistics needs a touch of the artist's insight; he needs a sensitivity to the different temperatures and colorations of the various kinds of money whose movements he seeks to measure.

To be a bit more specific, let's look at this country's international liquidity position. The figures show simply the stark fact that there are almost \$26 billion of foreign-owned short-term claims against the United States, and that the United States has in hand only \$15½ billion worth of gold bullion -- in this cruel world the only commodity which in the end is acceptable to our international creditors in settlement of our obligations to them. Technically -- or so the figures say -- we're disastrously over-extended. But what utter nonsense!

The total claims figure, for instance, doesn't say that almost \$5 billion of our short-term debt is owed to international institutions, such as the World Bank and the IMF, and that the great bulk of these IOUs are certain <u>not</u> to be presented at the Treasury's gold window. And as you further look behind the bare claims figures, you quickly realize that there are plenty of other items

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that don't threaten Mr. Dillon's stock of gold. Canada, our Number One trading partner, for example, holds some $3 billion of claims against the United States. But for the most part certainly, these are dollars which Canadians need as working balances in view of the essentiality and profitability of their business activities with Americans. Canadians simply could not turn in any appreciable percentage of these dollars and continue to carry on business as usual with the United States. Yet there is no reference to, or even hint of, such facts of life in the statistical tables.

What about the claims of the U.K., the claims of Japan, the claims of Italy? If we settled all the claims of these three, a third of our gold supply would be gone. But what are the probabilities? The British Treasury needs just about every dollar asset it can lay its hands on to supplement its meager gold holdings as backing for its own hard-worked currency. British bankers and businessmen are employing every dollar they can borrow or beg to finance more and more profitable business, from Hong Kong, to Melbourne, to Stockholm. Are they likely to exchange an earning asset for a sterile one like gold on a wholesale basis? Japan to date at least simply hasn't been able to afford the luxury of tying up many of her assets in gold. In fact, despite her growing prosperity, Japan holds less and less gold in her external reserve position all the time. Italy, in her economic rebirth, seems to have a refreshingly realistic view of the relative value of dollar holdings versus gold hoarding. Of course Italy, like Japan, besides owning also owes a huge amount of dollars, and short-term dollars at that. France, Switzerland, Belgium, Holland, and some others are different, in that traditionally they just don't feel comfortable unless the ratio of their gold holdings to their total holdings of liquid resources is at a certain, and usually very high, level. There is a painful reason for this in the individual histories of their respective currencies.

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The point of all this is that in our statistical summaries there is no attempt to measure the relative "hotness" of the vast array and variety of the claims on us. We need a modern Gabriel Fahrenheit, equipped with an instrument of extraordinary sensitivity, to go to work on this problem. Happily, there may be a ray of hope in just this area. President Kennedy has recently appointed an 8-man study committee headed by Edward M. Bernstein, to review our balance-of-payments statistics to determine whether they're producing the sort of illumination that is called for. I happen to know two of the members quite well: Walter Hoadley of Armstrong Cork and Roy Reierson of The Bankers Trust. If their talents are typical of the committee as a whole, I am sure the group will come up with a report of tremendous value. I hope the committee will go beyond the statistics themselves and emphasize that the really critical need is for astute and enlightened interpretation.

In stressing that the raw figures aren't always what they seem, I hope I haven't created an impression of complacency about this country's international liquidity position or about our balance-of-payments deficits. I hardly can afford to do that. I earn at least a part of my salary worrying about the country's payments deficit and interpreting each new set of statistics to Morgan Guaranty's customers. The country has a real and serious problem in this area, and my associates and I are far from satisfied with the progress we've been making toward a solution. But no purpose is served in exaggerating the problem or in getting worked up about it for the wrong reasons. I am constantly probing and pushing for a better and more rational understanding of our difficulties, for I am very much afraid that until such understanding grows, both in private and official circles, we're going to continue to do things, in our ill-informed anguish over the situation, which are bad for our businesses, bad for the dollar in the end, and in sad contradiction of the still valid American tradition of free movement of men, money, and merchandise.

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Our payments statistics as reported over the past several years have had perverse effects of the most extreme sort. In 1961 and 1962 they seemed to be saying that things were getting a lot better for the U.S. internationally, when actually they weren't. What happened in these years was that the official figures were prettied-up by the inclusion of a lot of special, nonrecurring transactions that happened to favor the U.S. So far in 1963 the published payments statistics have seemed to tell a story of drastic deterioration for the United States internationally, when actually there has been little essential change in the country's basic position. What happened this year is that we stopped getting some of the one-shot breaks and indeed were victimized by a number of adverse developments that are probably in no way indicative of long-term trends. The fact is that for the past several years we've been bumping along with "true" annual deficits of something over $3 billion and have not been roller-coasting in the wild manner that the figures have indicated. A persistent $3 billion deficit or more is plenty to worry about and should have kept us continuously at work devising suitable correctives. Unfortunately, the manic-depressive state of mind produced by the gyrating figures has prevented us from fashioning a sensible and balanced program of attack. What especially worries me now is that we may, because of the extremity that seems to be disclosed by this year's second-quarter results, grasp unthinkingly at any policy means that is presented.

The unrelieved starkness of the second-quarter statistics -- showing a rise in the payments deficit to $5.2 billion at an annual rate -- was clearly a major reason for the Administration's proposal of a so-called interest-equalization tax. This measure is wrong on so many counts that it's difficult to know where to begin one's comment.

Philosophically, it flies right in the face of America's strong and proper traditions of favoring more freedom for the movement of capital, not less;

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freer, not more protected, markets; open competition for all comers, not sheltered markets for the infirm and discrimination against the strong. The proposed measure is called an equalization tax; equalization for whom? It really is simply an ingenious tariff, a tariff on capital this time -- not on goods.

A second major flaw in the "equalization" scheme is a subtler one, and a more pernicious one. This one I have come face to face with on an almost daily basis in my conversations with American businessmen, more particularly the financial officials of American corporations, large and small, whose primary occupational responsibility is the safety and future growth of the assets of their companies' stockholders. Does this proposed tax measure, they ask, forecast more stringent capital controls? Won't these come if the tax, in its presently proposed form, fails -- as is likely -- to bring the capital-flow benefits which it professes to seek? If so, won't the country move toward the concept of a Capital Issues Committee, or toward moral suasion programs aimed at limiting capital outflows of all sorts? So hadn't we better protect ourselves and our stockholders by putting a little extra money abroad -- now, rather than later when the funds will, or may, actually be needed there -- so that we'll be sure to be in a position to go on with the build-up of our position in the vital world market? I try to persuade them to go slow, to ask themselves whether they really need more capital abroad, to make sure that they first have exhausted all the reasonable possibilities of raising bank and term money which are available to them in foreign markets. Here, of course, I digress to explain the unique facilities of Morgan Guaranty's branch system in Europe, our Edge Act affiliations at key spots there and elsewhere, our proven ability to coax funds out of correspondent banks in still other countries. Then I point out that their optional remittances of funds to points abroad, to deposits in the Euro-dollar market, their setting up of cumbersome escrow arrangements with XYZ bank in, say, Penang, if indulged in on a massive scale, can beget the very

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thing every self-respecting American dreads -- the sad day when it will clearly be necessary to junk our basic system of freedom of the individual to do with his money what he wants, and according to his own best judgement. You can be sure that when officials in the Treasury were debating the wisdom of the Interest Equalization Tax, they were aware of the possibility that they could incite a speculative run from the dollar, motivated, not by cynicism, but by responsible concern for the future of the dollar. I feel that they underestimated the long-term dangers which lie in this direction.

Perhaps some departure from American tradition, with all the psychological risk such a break entails, would have to be accepted if the country had really reached a state of dire extremity in its economic and financial relations with other countries. I don't believe that we've come to such a point, however. We tend to discount our still very large gold holdings, our drawing rights at the IMF, and our important currency arrangements and understandings with the principal nations of Western Europe. These give us considerable leeway to devise correctives that are both suitable and sound. And actually, while the results have not yet shown in a dramatic way in our trade statistics, there is little doubt in my mind that our competitive position is fast improving vis-à-vis other industrialized nations because of our record of general price stability at a time when inflation has been reawakened abroad. To date, foreign export prices have not reflected this development to any appreciable extent, because foreign manufacturers have been able to absorb cost increases by shaving the relatively fat profit margins they have enjoyed. But there are limits to cost absorption, and I think these are being increasingly approached, particularly in Western Europe. This is a latent plus working for the United States, which is not sufficiently appreciated.

A condition of extremity certainly is not demonstrated merely by the second-quarter bulge in the payments deficit. This was in large part the product

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of exceptional elements, a fact which should be apparent to anyone who is not a captive of the hypnotic power of pure statistics. A variety of ingredients combined to produce the distorted results, including a sharp drop in investment income from abroad, which is out of harmony with the strong longer-run uptrend in this item, and the fluke of heavy June 30 window dressing by European banks, which was immediately reversed after the statement date. (This reversal has neatly been dubbed "window undressing".) Most important of all, the second quarter witnessed a continuation -- and indeed an acceleration -- of heavy sales of foreign securities in the U.S. capital market. Such sales have been subject to special influences all this year. In particular, the huge total of Canadian securities sold in the United States so far in 1963 doesn't look like anything from which a trend should be projected into the indefinite future. Adjustment should properly be made for such things as the big borrowing by the Canadian government to rebuild exchange reserves and the large borrowing by the Province of Quebec to take over public utilities. These were extraordinary transactions that confuse the payments analysis when indiscriminately lumped together with more normal items.

Of course, a problem does exist with regard to the outflow of capital from this country. But to focus narrowly on money going out via the route of sales of foreign security issues -- and to blow up the dimensions of this particular difficulty -- provides a poor basis for making policy. The real capital-outflow problem is a very general one, reflecting relatively low interest rates in this country and relatively poor profit opportunities, and it shows up not just in one but in many components of our payments accounts. We are all familiar, of course, with the huge sums of short-term money that have been seeping across our borders in search of better investment outlets than exist at home. Some of this flow has been checked by the recent tightening in U.S. monetary policy. This tightening came a year or so too late and perhaps has been too little, as well. But I guess

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we won't be seeing much more in the immediate future. There is less general awareness that a steady uptrend has been under way in the outflow of American capital into direct investments abroad. The annual rate of private U.S. direct investment overseas climbed to almost $2 billion in the first half of 1963, and it's a fairly certain bet that this exodus will be stimulated if the "equalization" tax becomes law since direct investment is explicitly exempted in the bill now before the House Ways and Means Committee. Long-term bank lending to foreigners has also been on the rise, and this trend is already being accentuated by the exemption allowed for in the proposed "equalization" measure. As further testimony to the general nature of this country's capital problem, there exists the steep decline which has been in progress in foreign investment, both portfolio and direct, in the United States. In 1959, foreign long-term money amounting to $709 million flowed to this country. Last year the figure was down to $271 million, and it appears to be running still lower this year.

These considerations strongly suggest to me the desirability -- indeed the necessity -- of a broadly-gauged policy attack aimed at the total context of capital incentive. I know of only one action that would adequately fill this requirement. That is the enactment of appreciable reduction in income-tax rates, as is proposed in H.R. 8363 now before Congress. This measure should be strongly supported not so much for the domestic reasons usually advanced, but rather because tax reduction is the main hope for eliminating the country's payments difficulties. A cut in tax rates along the lines proposed would add directly to the prospective after-tax profitability of investment projects and in doing this should have the effect of inducing Americans to keep more of their money at home and of encouraging foreigners to bring more of their money here. Moreover, if tax reduction proves the effective stimulant that most economists think it will, the resulting larger volume of business activity in this country will tend to keep American corporate

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funds at home, simply because cash needs will be greater. And perhaps most important of all, a stronger domestic economy would provide new scope for additional monetary action aimed at making interest rates in this country competitive -- or hopefully, more than competitive -- with those abroad. Tax reduction, in brief, is the foundation of a fully-rounded payments program, one involving an imaginative orchestration of fiscal and monetary themes. I only regret that the Administration didn't concentrate its efforts along these lines with boldness much earlier. For too long, unfortunately, the tax measure was treated, as one writer has aptly put it, as something misplaced and unwanted in the lost-luggage department.

Admittedly some inflationary risk is involved in cutting taxes. And nothing could be worse just now than the reactivation of inflation, just at a time, as mentioned earlier, when we may be on the verge of realizing some competitive strides in international markets. But the risk here can be minimized if, as we cut taxes, we also move to bring the expenditure side of the Federal budget under control.

This is a big "if", to be sure, but there is some real promise that it may be fulfilled. This Administration, regardless of the predilections of some in it, is being brought under tremendous pressure to do something to arrest the upward spiral in Federal expenditures. And this pressure emanates not just from such key Congressmen as Wilbur Mills, whose statement of September 16 on spending should be read, but from the public at large, whose attitude on spending appears to have grown increasingly firm. Whether or not the tax bill is amended by attachment of a spending ceiling, the Administration from this point on is going to be under strong moral compulsion to make good on the assurances it has been giving with respect to Federal expenditures. It could even be that the request for new obligational authority contained in the fiscal 1965 budget message will be appreciably below the level requested this year. And if things work out this way, it

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would mark a sharp reversal of the pattern of increase that has prevailed in recent years.

As I stand here and say these things, I suspect some of you are thinking, "Here's another Yale-type liberal, taken in by the New Frontier." Well, you could be right, but I don't think so. Granted, I want this tax reduction so much for the sake of our balance-of-payments problem that I may have lost some perspective. But I've tried to guard against that, and I sincerely believe there is a good chance that the country's mood will be translated into actual expenditure restraint, especially if the opponents of footloose spending keep the pressure on. I hope all of you, irrespective of party affiliation, will work to keep it on.

This talk of mine has taken many abrupt turns. In the process I'm afraid it has cut some corners and left a lot of ground uncovered. I'm open to questions, if anyone has any, and if WAM permits. Just one final thought:

In the words of Charlie Brown (I see that your Cincinnati papers carry this charming philosopher too), "Good GRIEF" - let's not get discouraged and panicky about the payments problems of the United States - there's real hope that we are rapidly developing a sound payments program, with tax reduction its cornerstone. There are signs (not yet statistically revealed, but felt in the exchange markets in New York and elsewhere) that our third- and fourth-quarter balance-of-payments figures may be so changed as to provide the Administration with the excuse it needs to bury its ill-begotten monster, the "interest-equalization" tax.

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